

Property Research Note

22nd April 2009

Subdued outlook for New Zealand commercial property

- **Recent developments**
 - The credit crisis has negatively impacted all asset classes.
 - To date, direct property has not undergone the significant re-pricing experienced in the listed property sector; with returns moderating to 9% during the year to December 2008 compared with -21% in the NZREIT sector.

- **Short-term outlook**
 - We anticipate further weakness in direct property returns due to deteriorating space market fundamentals, slowing economic activity and softening capitalisation rates.
 - The greatest decline in returns will be in lower quality assets, whereas high quality (core) assets with secure income streams should fare relatively better.
 - Investors expected to focus on defensive products with exposure to core assets.

- **Risks**
 - A prolonged and severe downturn in global economic growth as a result of the negative fall-out from the credit crisis.
 - Forced asset sales in a thin market as a result of vendor liquidity issues may result in prices initially overshooting on the downside.



1. Introduction

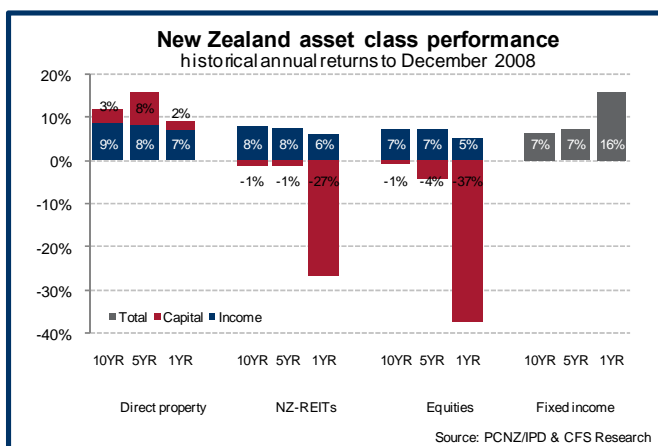
The performance of all aspects of property investment has deteriorated during 2008, mainly as a result of the global credit crisis and a re-focus on risk and the move towards the de-leveraging of balance sheets. The freezing of credit markets and the flow-on effects across broader financial markets led to a re-rating of investment risk across all asset classes. This situation, coupled with what appears to be the threat of a prolonged global economic downturn, is resulting in weakening New Zealand commercial property space market fundamentals (SMFs), predominantly on the demand side.

The question to ask is: How severely will increasingly negative market conditions impact the outlook on pricing of commercial property in New Zealand? This note aims to address this question and outline a number of key factors pertinent to the medium-term (2-3 years) prospects for the sector.

2. Overview of investment performance

Recent investment performance across a majority of asset classes has been significantly impacted via the global financial crisis.

Figure 1

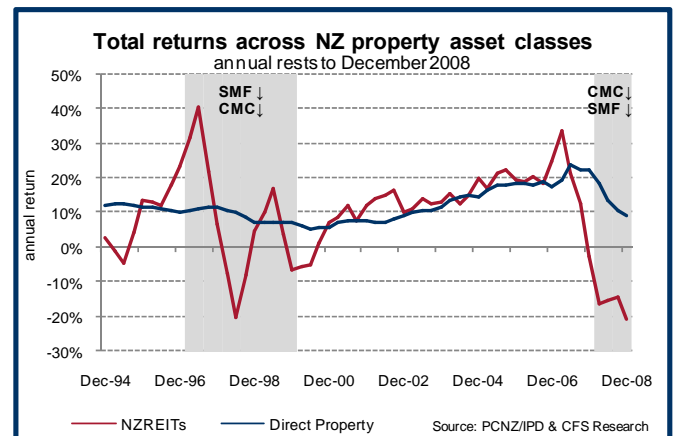


This is highlighted in Figure 1 which shows the total return performance on one, five and 10 year time horizons for Direct Property (PCNZ/IPD composite property index), NZ-REITs (NZX Property Index), Equities (NZX All Ordinaries) and Fixed Income (CSFB NZ GS). Listed markets (including equities and REITS) have borne the brunt of this, as a consequence of their highly liquid characteristics. In the year to December 2008, equities fell by 37%; whereas listed property declined by 21%. Conversely; fixed income (FI)

experienced above average returns (+16%) over this same period – a result of declining world official interest rates and a desire by investors for stable income-yielding assets. Against this, direct property continued to provide a solid total return (+9%) over this time; however, recent performance has weakened compared to the five and 10 year historical average.

Focusing on real estate investment performance, Figure 2 shows rolling annual total returns for the NZREIT sector and direct property for the period December 1994 to December 2008.

Figure 2



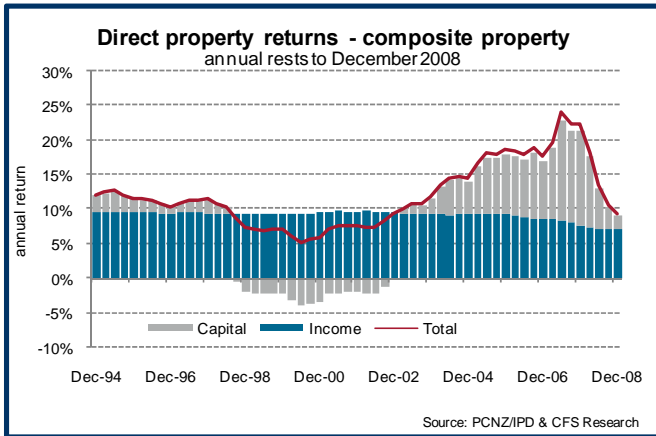
The shaded bars highlight periods where the property market was characterised by adverse conditions in both capital market conditions (CMCs) and SMFs.

The interval between March 1997 and December 2000 coincides with a period that saw adverse SMFs such as rising vacancy rates and a contracting domestic economy, as well as unfavourable CMCs characterised by turbulent financial markets as a consequence of the Asian financial crisis in 1997, and the fall-out from the collapse of the hedge fund Long Term Capital Management (LTCM) in the US in 1998.

The current situation is due to the credit crisis which has spilled over into the real economy, resulting in a marked slowdown in a number of the world's developed economies, including New Zealand.

Total returns for direct real estate are expected to show a continued weakening growth profile in the short- to medium-term as seen in Figure 3. This is predominantly due to falling capital returns, with more and more appraisal-based valuations starting to incorporate the rising risk premia, increased cost of credit, as well as falling rental growth.

Figure 3

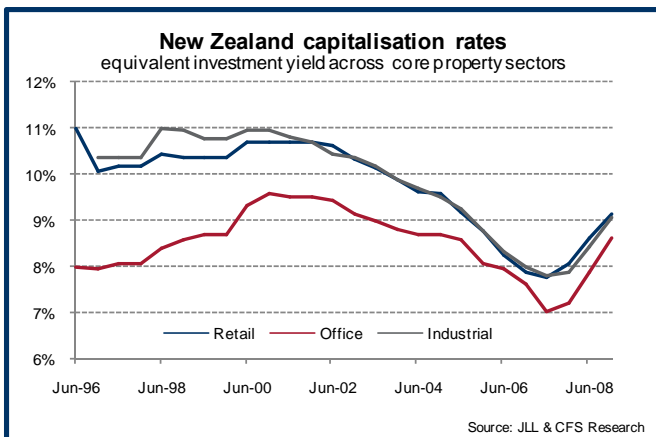


However, while there is a high probability of negative capital returns in the next 12 month period, they are not anticipated to fall to the same extent as the listed sector. This is due to the listed sector being negatively impacted by additional factors, such as the heightened volatility in the general equities market and spill-over effects from the deterioration in the Australian REIT sector during the past 18 months.

3. Movements in capitalisation rates

Figure 4 shows historical trends in capitalisation rates for the office, retail and industrial sectors in New Zealand. Note the period of yield compression (i.e., trending down) over the past several years has reversed with recent data showing yields weakening across the three sectors - largely triggered by the global credit crisis.

Figure 4



This softening is based on appraisal assessment as a result of a lack of significant transactional sales

evidence. Yields are ranging between 8.6% and 9.1% as at December 2008 compared to 7.2% to 8.1% at the peak of the market 12 months ago.

The main reasons yields firmed as much as they did include: i) low and stable interest and inflation rates; ii) cyclical favourable space market fundamentals (solid rental growth and falling vacancy rates); iii) solid investor demand for real estate investment. This latter point was underpinned by a re-rating of risk; where investor expectations of risk were down-weighted against traditional asset classes.

The softening in yields also reflects a flight to quality which should restore the historical spread in the risk-premium across asset grades. As such, there will be greater softening in yields for secondary grade than for prime assets.

4. Prospects for investment performance

Key drivers for property investment performance in New Zealand include: economic growth and space market fundamentals, the cost of debt, risk premia across asset classes and investor demand.

Economic growth and space market fundamentals

The New Zealand economy contracted by 1.9% over the year to December 2008 – echoing the large falls in activity seen in most industrialised economies. A further worsening in activity is expected over 2009, with particular weakness concentrated in the external sector, business investment and residential construction. However, this will be partially offset by significant stimulus from loose fiscal and monetary policy.

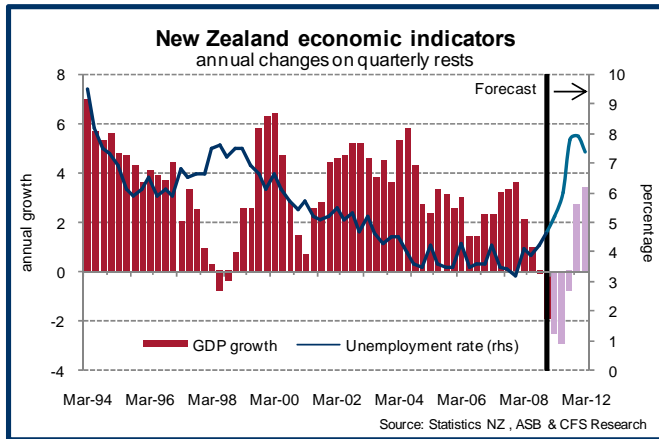
Weak global and domestic demand has lead to deterioration in the New Zealand labour market. Between December 2007 and 2008 the unemployment rate has risen from a low of 3.2% to 4.3%. The unemployment rate is expected to increase further with firms increasingly looking to manage staffing levels to reflect the reduced level of demand.

Figure 5 shows historical and Auckland Saving Bank¹ (ASB) forecasts for New Zealand economic growth and unemployment. ASB expects activity will contract by more than 2% during 2009, with no improvement in growth emerging until late 2010. Furthermore, they anticipate that the unemployment rate will rise

¹ ASB is part of the Commonwealth Bank of Australia group

substantially over the next 18 months, with a chance of going above 7%.

Figure 5



Subdued employment conditions will continue to weigh heavily on SMFs during 2009; particularly in regards to the demand for office floor space and retail turnover growth. Retail turnover is already weak, declining 6.9% (seasonally adjusted) during the year to February 2009, which is significantly down on the 7.7% annual growth for the year to February 2008. As seen in Figure 6, vacancy rates across the Auckland (A) and Wellington (W) commercial property markets rose for most of 2008 after reaching historic lows (on average) in December 2007.

Figure 6

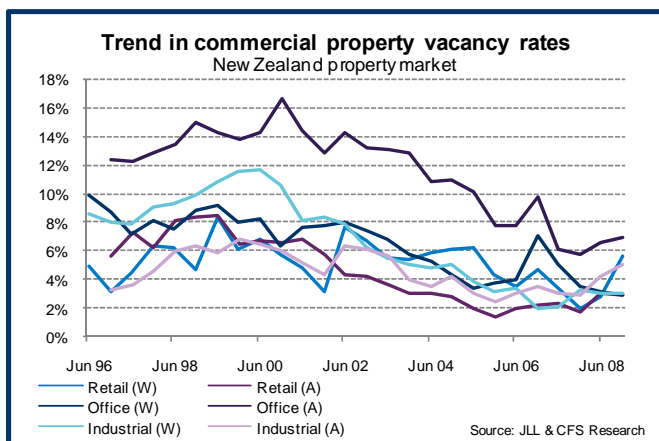
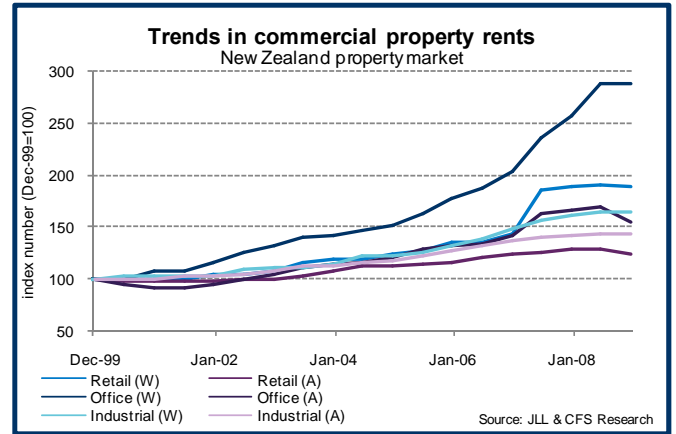


Figure 7 shows rents for the office, retail and industrial sectors in Auckland and Wellington in index form to December 2008. As can be seen, the weakening economic and space market environment is weighing negatively on rental growth across the commercial property sectors. Subdued rental growth in the near term will have a negative impact on the outlook for commercial property pricing metrics.

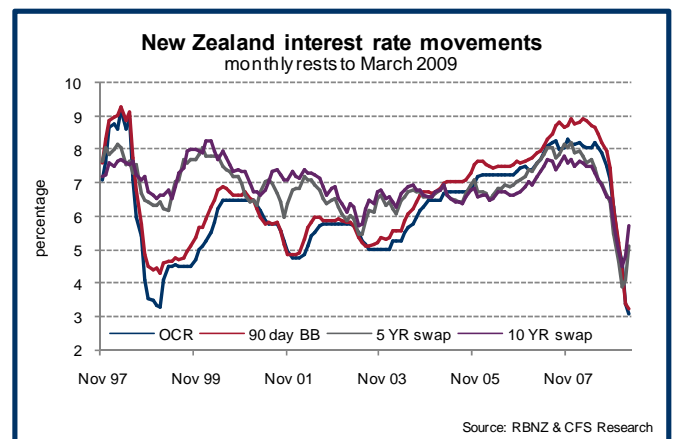
Figure 7



Cost of debt

The cost of debt is being determined by the interplay of two opposing forces. On the negative, the credit crisis has impacted liquidity and triggered a re-rating of risk across debt markets. This has resulted in a general rise in the cost of credit across both the maturity profile and quality spectrum. The positive has been the substantial cuts in policy interest rates by a number of central banks across the global – including the Reserve Bank of New Zealand (RBNZ). The RBNZ has cut its official cash rate (OCR) by 525 basis points (bps) since June 2008.

Figure 8



The outcome of these two opposing forces is illustrated in Figure 8, which shows the movements in rates across the OCR, 90 bank bills, and 5 and 10 year swap rates in New Zealand from December 1997 to March 2009.

As can be seen, the significant reductions to policy interest rates have been sufficient to produce large falls across the maturity spectrum. ASB anticipates an additional 100bps reduction in the OCR during 2009, to

2%, as a way of supporting the domestic economy. It expects this to be the low point of this easing cycle, with the OCR forecast to rise to 3% by 2010 and greater than 5% by 2011 as the economy recovers and inflationary concerns return. Low interest rates will have a positive effect on commercial property investment markets. However, it will be the ability of investors to source debt that will be most important and this will take time as credit conditions remain fragile. We expect that the net effect for commercial property investors will be moderately positive.

Risk premia for New Zealand real estate

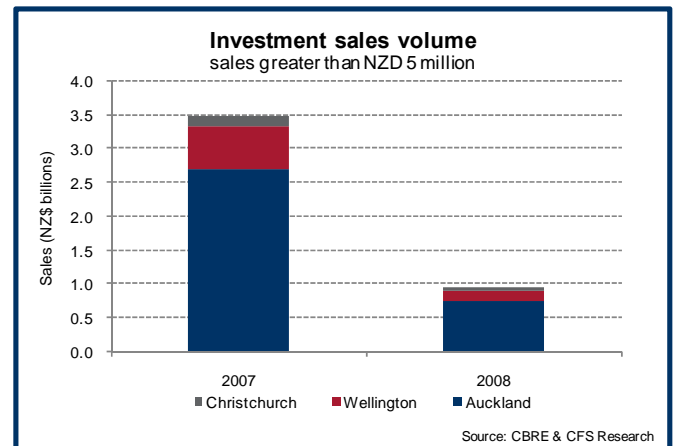
The credit crisis has resulted in a re-rating of risk across all asset classes; as a result, the risk premia for property is increasing. However, the impact will be greater for poorer quality assets as these experienced the largest downward pricing of risk relative to higher quantity assets.

Nevertheless, there is also a re-rating of risk across countries. Given the relative size of the New Zealand economy and property market, a given property is likely to attract a higher risk premium compared to a similar asset located in larger markets such as Australia for instance. This has been the case in credit markets where a spread of more than 50bps has emerged between CDS² on Australian and New Zealand Sovereign debt. We anticipate this heightened risk aversion to continue for the remainder of 2009 and will therefore weigh negatively on commercial property pricing.

Investor demand considerations

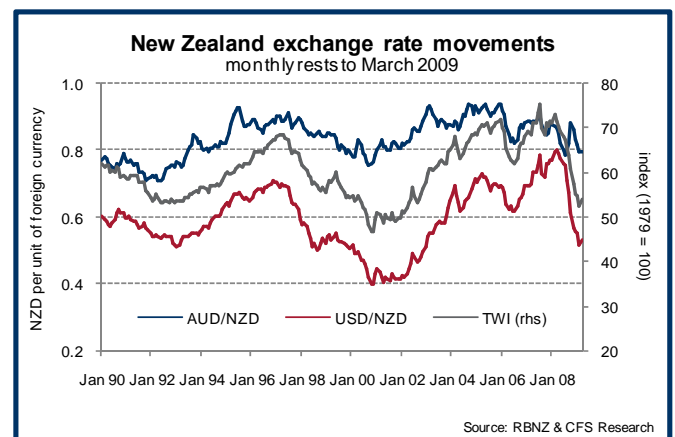
Transactions volumes were soft in 2008. CBRE recorded NZD 3.5 billion in property transactions (based on sales greater than NZD 5 million) for the three main cities in New Zealand in 2007 which involved 204 properties. This amount fell 72% during 2008 to NZD 965 million (88 property transactions). This is illustrated in Figure 9. The higher price bracket of NZD 20 million plus was particularly weak with only eight sales in 2008 compared to 44 in 2007. The majority of activity in 2008 was from local buyers who accounted for 89% of sales volume, whereas foreign purchasers during this period made up only 8% with the remainder undisclosed.

Figure 9



Foreign investors (in particular Australian and Asian institutional investors) are significant holders of New Zealand commercial real estate. One positive development which may spur a greater inflow of capital into commercial property investment in 2009 is the significant depreciation of the NZD during recent times. Figure 10 presents historical cross rates for the Australian (AUD) and US (USD) dollars as well as the Trade weighted Index (TWI) to March 2009.

Figure 10



A depreciating currency makes a given asset located in New Zealand relatively cheaper for a foreign investor to purchase. We expect additional weakness in the NZD in the next six months due to its linkages to global growth prospects (which are weak as well). ASB expects the NZD to strengthen during the second half of the year primarily due to expected USD weakness. The prospects of an unwinding of currently low interest rates in 2010 will also provide additional support to the NZD. As such, the impact will be broadly positive on investor demand, through primarily in the near term and only for foreign investors.

² Credit Default Swap – analogous to an insurance policy in case of default.

5. Outlook for property investment pricing

Following the intensification of the credit crisis over the second half of 2008, the medium term outlook for New Zealand commercial property pricing metrics (cap rates, rental growth and discount rates) have all deteriorated.

Discount rates are set to increase over the short term. This will be the result of a combination of factors including a weaker macroeconomic environment, moderate rental growth and rising risk premia at a time of subdued investor demand.

Figure 11

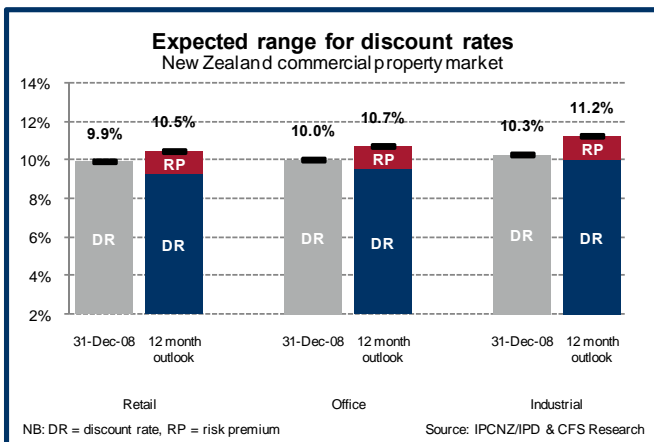


Figure 11 shows commercial property discount rates (DR) in New Zealand as at 31st December 2008 (grey bar) and the expected trough in 12 months time. In gauging the outlook we started with our outlook for Australian discount rates³ (blue bar) then compared discount rates over time between Australia and New Zealand. Historically, there has been a positive spread of between 50bps (at the peak) and 80bps (in the trough) between the two. However, given the heightened focus on risk we also considered the lack of relative liquidity in the New Zealand commercial property sector compared to larger markets in Australia and elsewhere. Furthermore, we made considerations for interest rate differentials and potential FX movements. In combining these considerations into a qualitative 'risk premium' (RP) measure, we arrived at our short-term (12 month) estimate for average office, retail and industrial discount rates in New Zealand.

Discount rates in New Zealand are expected to range from 10.5% in the retail sector to 11.2% for the industrial sector. These represent the low point and will vary depending on asset quality, with greater increases

for lower quality assets where income streams are under greater pressure.

While the first phase of the global financial crisis focused on the re-rating of risk across all asset classes. The next phase, which is still ongoing, involves the de-leveraging of balance sheets which could see a number of forced sales of property. If there are a sufficient number of sales which transpire, then these sales will serve as market evidence even if that realised market price is below fair value. As such, there is a risk that prices could over-shoot on the downside in the short term.

However, we expect pricing to firm moderately over the medium term (2 – 3 years). This will be driven by the larger foreign institutional investors re-entering the commercial property market to take advantage of these temporarily low values coupled with improving capital markets and strengthening space markets. Nevertheless, property value metrics are not likely to return to pre-credit crisis levels, which could be considered abnormal pricing by historical measures.

³ Please refer to the CFS Research Property Research Note: The pricing of the Australian commercial property market: an update, 16th January 2009.

CFS Research has a global reach and the expertise to tailor research to your needs.**Contact details**

Anthony De Francesco	Head of Research	+61 2 9303 3598
Luke Hartigan	Senior Investment Analyst	+61 2 9303 2625
Mary Culjak	Research Assistant	+61 2 9303 3518

For further information**cfsinstitutional@colonialfirststate.com.au****Head of Business Development, Australia and New Zealand**

Tony McFadyen +61 2 9303 2699

Institutional Account Management

Jeremy Edmonds +61 2 9303 2695

Daniel Bristow +61 2 9303 6311

Institutional Business Development

Peter Weldon +61 2 9303 6860

Matt Russell +61 2 9303 7024

Ali Karmali +61 2 9303 6070

Liz Krajewski +61 2 9303 2927

Helen Squadrito +61 2 9303 6142

Nadene Moore +61 3 8628 5615

Hugh O'Neill +61 2 9303 6116

Simon Good +61 3 8628 5681

Lucas Rooney +61 7 3328 5875

DISCLAIMER

Product Disclosure Statements (PDS) and Information Memoranda (IM) for the funds issued by Colonial First State Investments Limited ABN 98 002 348 352, Commonwealth Managed Investments Limited ABN 33 084 098 180, and CFS Managed Property Limited ABN 13 006 464 428 (collectively CFS) are available from Colonial First State Global Asset Management. Investors should consider the relevant PDS or IM before making an investment decision. Past performance should not be taken as an indication of future performance.

No part of this material may be reproduced or transmitted in any form or by any means without the prior written consent of CFS. This material contains or is based upon information that we believe to be accurate and reliable. While every effort has been made to ensure its accuracy we cannot offer any warranty that it contains no factual errors. We would like to be told of any such errors in order to correct them.

This material has been prepared for the general information of clients and professional associates of CFS. You should not rely on the contents. To the fullest extent allowed by law, CFS excludes all liability (whether arising in contract, from negligence or otherwise) in respect of all and each part of the material, including without limitation, any errors or omissions.

This material is intended only to provide a summary of the subject matter covered. It does not purport to be comprehensive or to render specific advice. It is not an offer document, and does not constitute a recommendation of any securities offered by CFS. No person should act on the basis of any matter contained in this material without obtaining specific professional advice.

Colonial First State Global Asset Management is the consolidated asset management division of Commonwealth Bank of Australia ABN 48 123 123 124.

Copyright © (2009) Colonial First State Group Limited.

All rights reserved..